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SUBJECT: EU Financial Sector Reform: De Larosihre Report, Barroso Plan, an Financial Services Action Plan II

¶1. (SBU) ummary. The de Larosihre group's report on EU Financial Services supervision is due to be released on February 25. Given strong disagreements within the EU on host versus home supervisory powers, the recommendations are likely to be modest. The report's conclusions will form part of a broader financial services strategy that Barroso plans to present at the G-20 Leaders' meeting. The strategy is also meant to provide the basis for an EC White Paper on financial services and a Financial Services Action Plan to be launched in 2H 2009.

De Larosihre Report

¶2. (SBU) In November 2008, European Commission President Barroso tasked former EBRD President and Banque de France Governor Jacques de Larosihre to lead a group to review EU financial supervision and make recommendations for its reform. The group is due to present its report on February 25. The report will focus on four areas:

- 1) The cause of the current crisis;
- 2) Overview of current financial supervisory system in the EU;
- 3) Proposed reforms of EU supervision; and,
- 4) Linking Europe's solution to the global financial system.

The report will also touch on several areas of regulation where the Commission is currently pushing reforms, such as Solvency II, Capital Requirement, and Credit Rating Agencies. However, it will not make detailed recommendations.

Supervisory proposals likely to be modest

¶3. (SBU) Both the group led by de Larosihre and Member States are deeply divided over how EU supervision should be reformed. Some Member States (e.g. France) favor moving to a strong Group Supervision regime, whereby a Lead Supervisor (or Home Supervisor) would have the final say in supervisory decisions, most notably in the allocation of capital amongst subsidiaries. Other Member States, particularly the smaller ones, want to retain strong Host Supervisor powers. Recent events, such as Fortis and Iceland, have led many supervisors to fear that Home Supervisors will leave subsidiaries insufficiently capitalized in the event of a crisis.

¶4. (SBU) De Larosihre hopes to find a compromise that retains some of the benefits of Group Supervision, while assuaging the concerns of host supervisors about losing control. Recent indications are that the report will likely emphasize the use of Colleges of

Supervisors, while not giving final say to Home Supervisors, and recommend giving the ECB some role in supervision.

Consistency between EU and global rules and defining international architecture

¶ 15. (SBU) De Larosihre has emphasized the importance of consistency between EU and global rules. This requires an international process to write global rules and put in place the right global architecture to tackle the three levels of activity that international institutions need to fulfill:

- a. Macro oversight
- b. Standard setting
- c. Enforcement of measures by nations

De Larosihre Report to Barroso plan

¶ 16. (SBU) After the release of the De Larosihre Report on February 25, its general conclusions will be pulled into a broader strategy paper on financial services that will be prepared by Commission staff. This strategy paper will be discussed by EU Finance Ministers on March 10 and discussed - and presumably endorsed - by EU Leaders at the March 19-20 European Council. Barroso then hopes to present the principles emerging from de Larosiere Report and the financial services strategy paper to G-20 Leaders as the EU consensus for reform of global financial regulation and supervision.

[This set of principles is being informally termed the "Barroso Plan".]

Barroso Plan to Financial Sector Action Plan II in H2 2009

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¶ 17. (SBU) The Commission financial services strategy paper and Barroso plan are meant to be the basis of a White Paper to be presented to EU Leaders in June. The White Paper will lay out a broad set of reforms going well beyond supervision, to include hedge funds, private equity funds, transparency, corporate governance, and market infrastructure. If EU Leaders accept the proposals of the White Paper, Commission staff plan to draft a detailed set of proposed reforms for announcement in the second half of 2009. This set of reforms is being informally called the second Financial Sector Action Plan - which is indicative of the broad scope and extent of the EC's plans for reform. Unlike the first Financial Services Action Plan launched in 1999, FSAP II will focus less on market integration and more on the strengthening of prudential rules. Sweden - as the next EU President - is reportedly planning to focus heavily on this issue.

Comment: Barroso pushing for financial services reform to help his reelection

¶ 18. (SBU) Much of the effort to reform financial services is reportedly being driven by Barroso. Barroso has come under strong pressure from Member State Leaders for not being sufficiently responsive to the financial crisis. The European Parliament has also heavily criticized Barroso for not pushing McCreevy to regulate the financial services industry more heavily. As he is maneuvering for reelection after the European Parliament elections in June, Barroso fears being criticized for not responding to the financial crisis and sees financial services reform as one of the few areas where he can demonstrate leadership.

MURRAY